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IN THE

Supreme Court of the United States

October Term, 1945.

BURTON-SUTTON OIL COMPANY, INCORPORATED, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT AND SUPPORTING BRIEF.

CULLEN R. LISKOW,
Attorney for Petitioner.

NORMAN F. ANDERSON,
W. W. THOMPSON,
ELIAS R. KAUFMAN,
Of Counsel for Petitioner.

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v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT.

MAY IT PLEASE THE COURT:

Petitioner, Burton-Sutton Oil Company, Incorporated, respectfully prays for a writ of certiorari to the United States Circuit Court of Appeals for the Fifth Circuit at New Orleans, Louisiana, to hear this cause and to review the decision of the Circuit Court of Appeals in affirming the judgment of the Tax Court of the United States. Petitioner respectfully shows to this Honorable Court:

SUMMARY STATEMENT OF THE MATTER INVOLVED.

This case involves income and excess profits taxes for fiscal years ended in 1936, 1937 and 1938. It was tried before the Tax Court on the pleadings (R. 3-36) and stipulations of fact (R. 45-54).

The Gulf Refining Company, hereinafter referred to as "Gulf," held an original lease on certain potential mineral land. On February 18, 1933, Gulf transferred a part of certain oil and gas rights granted in the original mineral lease to one J. G. Sutton (R. 46-51). Gulf was to receive 50% of the net profits (R. 47), but was not to be responsible for losses and expenses (R. 49). In addition to the share of net profits, Gulf retained:

(a) A part of its estate:
  (1) An overriding oil royalty for the benefit of a third party (R. 47)
  (2) All sulphur rights (R. 50)

(b) A part of its term: The right to terminate Sutton's use of the oil and gas rights at least thirty days prior to any obligation occuring under the original lease (R. 46)

(c) An advantage: The right to purchase all oil produced "during the life of this agreement" (R. 50, 51)

Petitioner acquired the contract from Sutton on February 27, 1933 (R. 45) and shortly thereafter proceeded to the development and operation of the property and obtained oil in paying quantities (R. 51). In accordance with the provisions of the contract, petitioner paid Gulf the following sums during the taxable years indicated (R. 51):

1936	$ 17,406.19
1937	232,498.94
1938	286,128.28

The foregoing amounts were claimed as deductions in the returns filed for the respective years and were disallowed by the Commissioner on the ground that they represented cost of the property recoverable through depletion allowances (R. 51). Depending upon the final decision, the depletion allowable will be determined under Rule 50 of the Tax Court (R. 52).

Petitioner's appeal to the Tax Court was prosecuted on the grounds (a) that the Gulf payments did not constitute income to it, or (b) were deductible as ordinary and necessary expenses.

The Tax Court sustained the Commissioner (R. 69). The Circuit Court of Appeals affirmed the decision on the grounds (a) that the agreement to pay a percentage of net profits does not grant an economic interest in the oil in place and were not made with respect to royalty interests retained by Gulf but were paid as consideration for the execution of the conveyance, and (b) that since control of operations was in the taxpayer and operating losses were to be borne by it, that the taxpayer and Gulf were not partners or joint adventurers (R. 88).

STATEMENT DISCLOSING BASIS UPON WHICH IT IS CONTENDED THIS COURT HAS JURISDICTION.

The jurisdiction of this cause is conferred upon this Honorable Court by Judicial Code, Section 240, as amended; United States Code, Title 28, Sections 347.

The judgment of the Circuit Court of Appeals was entered July 6, 1945 (R. 97).

QUESTIONS PRESENTED

(a) Was the petitioner taxable on the Gulf Refining Company's share of the net profits (1) Did Gulf have an economic interest in the oil, or (2) did Gulf receive it as a co-partner?

(b) If the Gulf Refining Company's share represented gross income to your petitioner, was your petitioner entitled to deduct such payments therefor as ordinary and necessary business expenses?

4.

REASONS RELIED ON FOR THE ALLOWANCE OF THE WRIT.

The reasons relied on for the allowance of the writ are that the Circuit Court of Appeals has decided important questions which have not been and should be settled by this Court; that these questions have been decided in a way probably in conflict with the applicable decisions of this Court and that they have been decided in a way directly in conflict with decisions of the Ninth and Tenth Circuit Courts of Appeals.

(a) The basic issue here is the same as in *Kirby Petroleum Company* v. *Commissioner*, Docket No. 1139 of this Court, to be heard on a writ of certiorari granted May 28, 1945, upon the taxpayer's application. The writ in that case was apparently granted in order to resolve the direct conflict in that decision of the Fifth Circuit Court of Appeals with the decisions of the Ninth Circuit Court of Appeals in *Commissioner* v. *Fehr Oil Company*, 144 F. 2d 27, and *Commissioner* v. *Anna Dickson Crawford*, decided April 21, 1945, 148 F. 2d 777, all of which involved depletion allowances on oil net profits payments.

Appeals in said cause entitled Burgess Storage Co. [illegible]
[illegible] Petitioner, vs. Commissioner of [illegible]
Respondent, No. 11275 on its docket, [illegible]
and that the said cause may be reviewed and determined
by this Court as provided by Section 240 of the Judicial
Code, as amended, and that your petitioner may have such
other and further relief or remedy in the premises as this
Court may deem appropriate and in conformity with the
provisions of the Judicial Code, and that on hearing hereof
this Honorable Court said judgment of the Circuit Court
of Appeals be reversed.

BURGESS STORAGE CO.,
INCORPORATED,
By CLIFTON R. LASKEY,
Attorney for Petitioner.

NORMAN F. ANDERSON,
W. W. THOMPSON,
CLIFTON R. LASKEY,
of Counsel for Petitioner.

IN THE

Supreme Court of the United States

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

I.

THE OPINIONS OF THE COURTS BELOW.

The opinion of the Tax Court is found at page 54 of the record and is reported in 3 T. C. 1187. The opinion of the Circuit Court of Appeals has not been reported but is found at page 87 of the record.

II.

JURISDICTION.

Stated under heading 2 of the petition.

III.

STATEMENT OF THE CASE.

A full statement of the case has been given under heading 3 of the petition and in the interest of brevity is not repeated.

IV.

THE LAW.

REVENUE ACT OF 1934:

"Sec. 22. Gross Income.

"(a) General Definition.—'Gross income' includes gains, profits, and income derived from salaries, wages, or compensation for personal services, of whatever kind and in whatever form paid or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever."

* * * * * * * * *

(26 U. S. C. A. 669, 1940 Ed.)

"Sec. 23. Deductions from Gross Income.

"In computing net income there shall be allowed as deductions:

"(a) Expenses.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity."

(26 U. S. C. A. 671, 1940 Ed.)

"Sec. 181. Partnership not Taxable.

"Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity."

(26 U. S. C. A. 738, 1940 Ed.)

"Sec. 182. Taxes of Partners.

"There shall be included in computing the net income of each partner his distributive share, whether distributed or not, of the net income of the partnership for the taxable year."
(26 U. S. C. A. 728, 1940 Ed.)

"Sec. 801. Definitions.

"(a) When used in this act—

* * * * * * *

"(3) The term 'partnership' includes a syndicate, group, pool, joint venture, or other incorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this act, a trust or estate or a corporation, and the term 'partner' includes a member in such a syndicate, group, pool, joint venture, or organization."
(26 U. S. C. A. 790, 1940 Ed.)

"Sec. 24. Items Not Deductible.

"(a) General Rule.—In computing net income no deduction shall in any case be allowed in respect of * * *"

* * * * * * *

"(2) Any amount paid out for new buildings or permanent improvements or betterments made to increase the value of any property or estate."
26 U. S. C. A. 675, 1940 Ed.)

REVENUE ACT OF 1936:

The applicable provisions of the Revenue Act of 1936 are identical with the foregoing.

V.

SPECIFICATION OF ERRORS.

1. The Circuit Court of Appeals erred in holding that the Gulf Refining Company's shares of net income constitute gross income to petitioner.

2. The Circuit Court of Appeals erred in holding that petitioner's payments of the Gulf Refining Company's shares are capital expenditures.

3. In the alternative, if the payments to the Gulf Refining Company are income to your petitioner, the Circuit Court of Appeals erred in failing to hold that the said payments are deductible as ordinary and necessary business expenses.

SUMMARY OF THE ARGUMENT.

Point A.

The Gulf Refining Company has an economic interest in the oil and its 50% share of the net proceeds from production is not gross income to your petitioner.

Point B.

Moreover, the Gulf contract is one of partnership or joint adventureship and your petitioner is not taxable on the distributive share of its co-partner.

Point C.

In the alternative, the payments are required to be made as a condition to the continued use and possession of the property and are ordinary and necessary business expenses.

ARGUMENT.

Point A.

The Gulf at all times had an economic interest in the oil. This interest is as great, or even greater than that of your petitioner, and your petitioner should not be taxed upon the income derived from that interest.

While depletion is not at issue here, the controlling principal is the same. This Court said in *Anderson* v. *Helvering*, 310 U. S. 404, 407:

> "It is settled that the same basic issue determines both to whom income derived from the production of

oil and gas is taxable and to whom a deduction for depletion is allowable."

The decision of the Fifth Circuit is, therefore, directly in conflict on this basic issue with the *Felix*[1] case of the Ninth Circuit where it was held that a landowner was entitled to a depletion allowance upon his only income from the wells, a 50% net profits payment. The recent decision of the Ninth Circuit in the *Crawford*[2] case was to the same effect.

The conflict between the Circuits on this fundamental issue is also seen in *Commissioner* v. *Kirby Petroleum Co.*[3] in which the Fifth Circuit decided the precise question involved in the *Felix* case contrary to the rule followed by the Ninth Circuit. This, obviously, was the primary reason for this Court granting the taxpayer's application for a writ of certiorari in the *Kirby* case.

In view of the foregoing, it is respectfully urged that, if for no other reason, your petitioner's application should be granted in order that it may be decided by this Honorable Court with and according to the same fundamental principles in respect to economic interests as may be found applicable in the *Kirby* case.

The decision here is also directly in conflict on the exact question involved with the Ninth Circuit's decision in *Holly Development Co.* v. *Commissioner*, 93 F. 2d 146. The facts there were that Argonaut had transferred leases to one Sinsheimer who was to pay operating expenses, make certain other payments and thereafter "all of the remainder of the proceeds, less cost of additional development, to be distributed 60% to Sinsheimer and 40% to Argonaut, inclusive of the monthly payment of $6,000.00 unless the drilling expenses exceeded the amount of $120,000.00, in which event the remainder was to be distributed 65% to Sinshei-

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1 *Commissioner* v. *Felix Oil Company*, 144 F. 2d 276.

2 *Commissioner* v. *Anna Vickers Crawford*, 148 F. 2d 777, decided April 21, 1945.

3 Decided March 5, 1945. 148 F. 2d 80; Docket No. 1139 of Supreme Court; certiorari granted May 21, 1945.

mer and 35% to Argonaut." The Holly Development Company acquired Sinsheimer's contract and made the payments as provided, including the percentages of net proceeds to Argonaut. The Commissioner contended there, as here, that the payments were capital expenditures made in connection with the acquisition of capital assets and were in reality a part of the purchase price and, therefore, includible in the gross income of petitioner. After thus stating these contentions, the Court said:[4]

> "We are unable to accept this view of respondent because, by the agreement referred to, Argonaut excepted and reserved to itself an interest in the lease and the oil."

The Fifth Circuit, in rejecting your petitioner's contention that Gulf had an economic interest, cited its own decision in *Quintana Petroleum Company* v. *Commissioner*, 143 F. 2d 588 (no application for certiorari), the *Kyle* case referred to above, and the so-called net profits cases of this Court, *Helvering* v. *O'Donnell*, 303 U. S. 370, and *Helvering* v. *Elba Oil Land Company*, 303 U. S. 372.

The taxpayer in the *O'Donnell* case at no time owned any interest in the oil and gas. He merely owned a part of the stock in a corporation which had oil properties and he exchanged his shares in a deal with the third person who agreed to acquire the corporation's oil properties and to pay O'Donnell, the stockholder, an amount equivalent to one-third (1/3) of the net profits from the oil operations. That is substantially different from the present case. Here, Gulf owned the entire working interest and agreed to share that interest with the petitioner upon the petitioner assuming the management and certain financial risks.

[4] Lest it be argued that this case was in effect overruled by or is out of harmony with *Commissioner* v. *Elbe Oil Land Development Co.*, 303 U. S. 372, it should be noted that Circuit Judge Garrecht, the organ of the Court in the *Holly* case, entered his dissent in the *Elbe* case (91 F. 2d 127, 130) expressing the view that Elbe was not entitled to a depletion allowance.

In the *Elbe* case, the taxpayer had owned the working interest but it made an absolute sale for $2,000,000.00 plus the agreement of the purchaser to pay additional money in the amount of one third (⅓) of the net profits if, after the purchaser had reimbursed itself for the cost of acquisition and all subsequent development and operating costs and expenses, there were any profits. As this Court pointed out (page 374), the agreement there specifically provided:

> "It is the intention of the parties to this agreement that the full ownership, possession and control of all the properties . . . shall be vested in Honolulu (purchaser) and Elbe shall have no interest in or to the said properties."

Accordingly, this Court held that after the execution of such a contract, the taxpayer had no further interest in the properties and was not entitled to an allowance for depletion upon the $2,000,000.00 on the theory that it represented capital.

Technically, in the present case, there was no sale. Gulf assigned only a part of its "estate" and only a part of its "term." Therefore, the agreement here to pay a share of the net profits is no mere personal covenant but it is a covenant running with the property.

Moreover, disregarding refinements of title, the art of the conveyancer and looking at the transaction broadly and to its practical aspects, it is clear that Gulf has an economic interest in the oil and gas. The Gulf Refining Company owned the entire working interest, and before the Sutton contract it admittedly had an investment in the oil and gas in place. Under the contract here, Gulf was given no money or other source to which it could look for the recovery of its

[1] Gulf specifically retained (a) an overriding royalty for the benefit of a third party (R. 47), (b) all sulphur rights (R. 50), and (c) the right to purchase all oil produced "during the life of this agreement" (R. 50).

[2] Gulf had the reversion of the oil rights under a covenant for reassignment by Sutton before the maturity of any obligation under the lease (R. 46).

investment except the production of oil and gas. The instant production was obtained, Gulf's capital investment commenced to diminish and thereafter it has shrunk as each unit is severed. Gulf's investment will be exhausted only when production cannot be had in paying quantities. On the other hand, petitioner does not enjoy Gulf's share of the net income. It derives no more benefit from Gulf's share than do the operators who share with the landowners in the *Kirby*, *Felix* and *Clanton* cases. Considering that such expenses are not taken into account in computing Gulf's share of the profits and that Gulf has its reversion of the oil rights, it is believed that Gulf's interests are actually greater than your petitioner's.

Point B.

In the event it is decided that Gulf has no economic interest in the oil, still your petitioner is not taxable on Gulf's share because, under the contract, the parties were limited partners. This was argued below but was rejected, the Court stating (R. 88):

> "It is argued that the taxpayer and its transferor were joint adventurers in the enterprise. Since complete control of all operations of the properties was in the taxpayer, and under the agreement all expenses and losses were to be borne by it, we deem this contention to be untenable."

Generally, as well as under local law of Louisiana, a special partner is prohibited from taking any active part in the business, under penalty of liability as a general partner, and the proportion of losses and expenses is regulated as

> "Ordinarily, special partners are denied the right to participate in the management of the firm business * * * under penalty of being liable as a general partner." 40 Amer Jur, page 479.
>
> "* * * And if any partner in commendam shall take any part in the business * * * such partner shall be liable to all the responsibilities of a general partner." *Louisiana Revised Civil Code* Article 2849

between themselves, by their agreement.[8] A limited partnership is recognized as taxable as an ordinary partnership, if not taxable as an Association, by the Commissioner's present Regulations.[9]

The Tenth Circuit Court of Appeals in *Reynolds v. McMurray*, 60 F. 2d 843, (certiorari denied) held that a joint venture existed notwithstanding that one party had no control over operations and had no personal liability for losses and expenses. The facts there were that one Armstrong and the Ohio Oil Company owned oil leases in the proportions of 40% and 60%, respectively, and on December 7, 1917, entered into an agreement which provided that the Ohio Oil Company should manage, control and develop the lease and should immediately drill a well thereon at its own expense. After completion of the well, the Ohio Company should continue to manage and operate the properties and should market the oil and account to Armstrong for his proportionate part thereof and should make monthly remittances to him after deducting the amounts due to it for expenditures made by it for him. Armstrong later assigned a part of this interest to William McMurray, the taxpayer, and thereafter the Ohio Company carried an account in the name of McMurray, crediting his account with the oil runs and charging him with disbursements and operations of the lease. The Ohio Company was obligated to make the disbursements to carry the Armstrong interest without any personal obligation on the part of Armstrong to make reimbursements. In substance, therefore, the contract was to receive a percentage of the net proceeds. The Commissioner was maintained in taxing McMurray with

[8] The proportion of profits to be received by the partner in commendam may be regulated by the covenant of the parties, as may also, with respect to each other, the proportion of losses and expenses to be borne by each of the partners. * * *" *Louisiana Revised Civil Code*, 1870, 2841. See also *I. T.* 2848, C. B. 1923-1, p. 6, where it was said "A sharing of losses is not, according to the best authorities, indispensable to a partnership" and S. T. 1261, C. B. 1920-1 p. 11, where an agreement was held to be a partnership although net losses were borne by an individual partner alone.

[9] Sec. 111, Sec. 29.3797-1.

the full amount of the gross proceeds applicable to his proportionate interest less deductions for expenses applicable to his interest upon the theory of a joint venture and before joint ventures were first included in the definition of a "partnership" under the Revenue Act of 1932. The Ninth Circuit followed in *Helvering* v. *Armstrong*, 69 F. 2d 370.

Even in the absence of the conflict created by the *Morgan* and *Armstrong* cases, there is an important question of Federal law involved in whether active participation in management and sharing of losses are essential to the establishment of a partnership for income tax purposes. That question has not and should be settled by this Honorable Court.

Point C.

In the event the Gulf's share of the net income is taxable as petitioner's income, the payments are ordinary and necessary business expense of your petitioner. It has been pointed out above that Gulf's assignment to Sutton was of a lesser interest than the whole of its estate and for a period less than its term. Accordingly, each payment made by Gulf is required as a condition to the continued use of the property and is deductible under the express provisions of Section 23(a) of the Revenue Acts of 1936 and 1938, supra. The deduction of these payments by the payor is consistent with the Commissioner's position in the *Kirby Petroleum* and *Crichfield* cases, supra, where he has sought to tax the person receiving such payments with the amounts as ordinary income (without allowance for depletion) and not as proceeds arising from the sale of property. It presents a question which has not and should be settled by this Honorable Court.

CONCLUSION.

It is respectfully submitted that this case is such as to call for the exercise by this Court of its supervisory powers, and We, therefore, respectfully pray that the petition for writ of certiorari to the United States Circuit Court of Appeals for the Fifth Circuit be granted.

CULLEN R. LISKOW,
Attorney for Petitioner.

NORMAN E. ANDERSON,
W. W. THOMPSON,
ELIAS R. KAUFMAN,
Of Counsel for Petitioner.